December 12th, 2016

MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Banks on both sides of the border

Gareth Watson, CFA
Derek Benedet, CIM, CMT

Canadian Banks – Steady as she goes

Over the past two weeks Canadian banks reported their fiscal fourth quarter earnings, covering results from August through October. All banks were either in line with or beat expectations barring Royal Bank who was a few pennies short. Here are our observations:

- Loan loss provisions, for most of the banks, fell quarter-over-quarter, highlighting Q2 as the high point this past year thanks to increased provisions taken in the energy sector
- Personal and commercial banking results were mostly positive
- After having a solid Q3, wholesale (trading and investment banking) operations were mixed, especially at Royal Bank where net income fell year-over-year
- Bank capital positions remain on firm footing while dividend growth track records remain intact
- Markets are content with those banks that beat expectations with solid share performance since Bank of Nova Scotia kicked off earnings season at the end of November

Q4/16 Earnings and Loan Loss Provisions

	EPS	Average Estimate	LLPs ($Millions) Q4/16	LLPs ($Millions) Q3/16	LLPs ($Millions) Q4/15
Bank of Montreal	$2.10	$1.85	174	257	128
Bank of Nova Scotia	$1.58	$1.51	550	571	551
CIBC	$2.60	$2.47	222	243	198
National Bank	$1.24	$1.20	59	45	61
Royal Bank	$1.69	$1.72	358	318	275
TD Bank	$1.22	$1.22	548	556	509

LLPs = Loan Loss Provisions

Source: Company Reports

Canadian Personal & Commercial Earnings

	Q4/16 ($Millions)	Q3/16 ($Millions)	Q4/15 ($Millions)	Q4/16 Net Interest Margin (%)	Q3/16 Net Interest Margin (%)	Q4/15 Net Interest Margin (%)
Bank of Montreal	592	562	562	2.53%	2.55%	2.55%
Bank of Nova Scotia	954	930	837	2.39%	2.38%	2.26%
CIBC	687	666	672	2.45%	2.48%	2.54%
National Bank	196	203	183	2.26%	2.25%	2.25%
Royal Bank	1275	1322	1270	2.63%	2.63%	2.65%
TD Bank	1502	1509	1496	2.78%	2.79%	2.84%

Source: Company Reports

Loan Loss Provisions:

Loan loss provisions were up for almost all banks year-over-year. However, we continued to see a decline in provisions taken from their peak this year in Q2. This was when most banks took the opportunity to increase charges in the oil and gas sector following the volatile decline in oil prices at the beginning of 2016. The exceptions to this trend were National Bank and Royal Bank who saw increases quarter-over-quarter.

Personal and Commercial Banking:

Easily the largest contributor to bank earnings, this segment was steady for all banks on a year-over-year basis. Compared to last quarter though, results were mixed. Bank of Montreal, Bank of Nova Scotia and CIBC saw solid increases quarter-over-quarter while the other banks saw results impacted by particular headwinds such as higher non-interest expenses.

RICHARDSON GMP

Wholesale banking:

This time three months ago, we were telling you about the solid performance for most banks in wholesale banking. However, the tone changed in Q4 as some banks (CIBC, Royal and TD, for example) were unable to maintain positive momentum in corporate & investment banking along with trading. Royal in particular had a difficult Q4 as results were both down on a quarter-over-quarter and year-over-year basis.

Wholesale Earnings

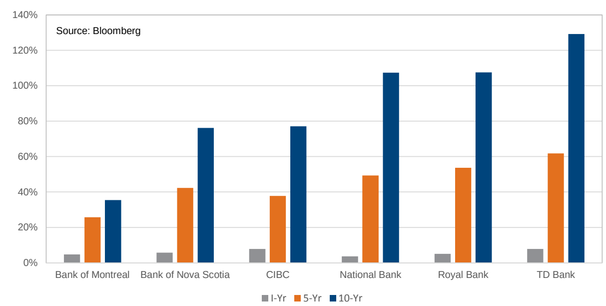
	Q4/16 ($Millions)	Q3/16 ($Millions)	Q4/15 ($Millions)
Bank of Montreal	396	322	242
Bank of Nova Scotia	461	421	325
CIBC	276	304	181
National Bank	191	171	162
Royal Bank	482	635	555
TD Bank	238	302	196

Source: Company Reports

Capital and Dividends:

Tier 1 capital levels for all of the banks increased quarter-over-quarter and we saw Bank of Montreal, CIBC and National Bank all increase their quarterly dividends as expected. Bank of Nova Scotia and Royal Bank are in a position to increase their quarterly dividends in three months' time as they normally have done so once every six months. TD will also likely bump its dividend next quarter, but it has moved increasing dividends from a semi-annual to annual basis.

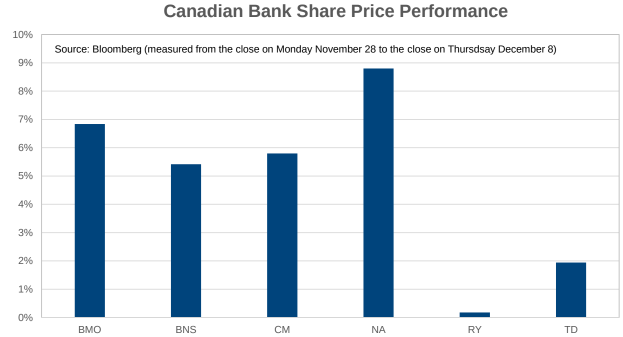
Canadian Bank Dividend Growth Rates



Share Price Performance:

One only has to look at share price performance since earnings were released to know that the market remains comfortable with the Canadian banking sector for the time being. All banks that exceeded expectations have performed exceptionally well, while TD's in-line earnings provided a small bounce and Royal's miss was greeted by a neutral response. However, all banks are currently trading at or near all-time highs.

Canadian Bank Share Price Performance



Overall, the quarter was generally positive for the Canadian banking group as only Royal Bank failed to meet earnings expectations. While the banks have done considerably well over the years, headwinds such as the interest rate environment will persist as we move into 2017. With that, expectations for earnings growth going forward will likely remain subdued in the mid-single digits next year.

U.S. Banks – It's been a long time coming

U.S. Banks have continued to shine in the gold-plated Trump world. U.S. Financials were up another 4.4% last week, bringing the performance since the U.S. election to an impressive +17.8%. Goldman Sachs hosted a Financial Services conference this week, and we're sure the mood in the rooms was ecstatic. Cocktail conversations recalling the glory days and hoping they might be making a comeback, were likely the norm.

Jamie Dimon in particular summed up the impressive performance of bank stocks since the election in his presentation noting that it's "*done on hope… That the Trump administration will be very good for kind of unleashed business per se and maybe improve the GDP and allow banks to do their lending and the banks will benefit a little bit from both higher rates and higher economic activity and possibly some reduced regulation. So, hopefully that will turn out to be true.*"

Hope. While it's nice to have it tends to be temporary, at least for investors. Eventually, this hope has to be seen through tangible results.

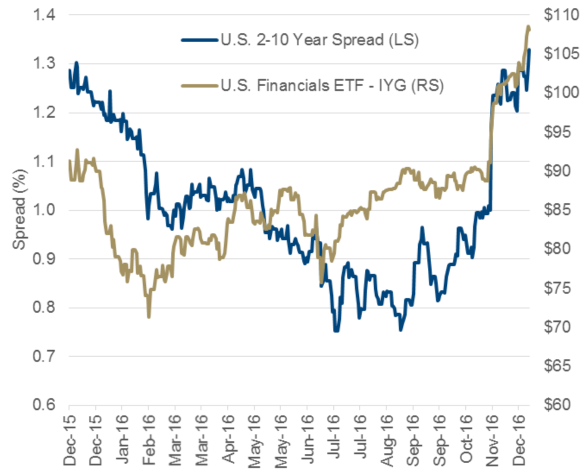
A steepening yield curve is usually taken as a positive sign for the economy and bank stocks specifically. It's a real tangible benefit. Net Interest Margin (NIM) expansion is a key driver for bank earnings. Following Donald Trump's victory, bond yields have shot higher, but the slope of the yield curve also became steeper. Over the past couple of weeks, despite yields still rising, the actual spread has stayed rather constant, meaning the pace of the steepening has slowed down. Not so with the performance of U.S. bank shares. Over the past two weeks, most of the big U.S. financial firms were up significantly. Hope as a driver tends to overreact.

The banks might just now be getting out of the penalty box following the financial crisis. To the right are long term looks at the sectors historical price to book ratio as well as the % market cap of U.S. Financials. Taking the longer term look puts this recent rally into better perspective. Valuations metrics are nowhere near excessive, with sector price to book levels of only 1.34%, and the sector as a whole is a long way off a 22% market weight. After underperforming for so long relative to the rest of the market, there is certainly room to run, but these moves are rarely in a straight line.

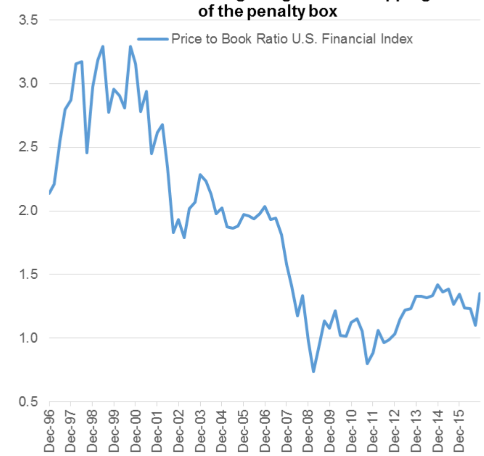
While we don't know how the market will react over the short term, it's fair to say that much of the positive outlook and narrative would already be priced into the markets. For now, as the animal spirits are still happy, optimism reigns, though it is flirting with exuberant excess. 94% of U.S. Financial companies are trading over their 50 day moving average and 98% are over the longer term 200 day moving average.

It's hard to see hope driving returns much further, without more policy specifics. Investors are betting on less regulations, but exactly what changes we'll see to Dodd-Frank or the Volcker Rule in particular remain to be seen. Those hoping for a complete repeal will likely be

Getting steeper, but are financials getting ahead of spreads?



Financial valuations getting close to stepping out of the penalty box



Time for Financials to regain their rightful place

disappointed. As far what we're doing from a portfolio standpoint, we're actively raising and tightening our revisit levels for many of our financial financials stocks that have seen strong gains recently.

Charts are sourced to Bloomberg unless otherwise noted.